

HUNTER WATER SUBMISSION TO IPART

DRAFT AUDIT GUIDELINE FOR PUBLIC WATER UTILITIES



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SUBMISSION TO IPART'S DRAFT AUDIT GUIDELINE FOR PUBLIC WATER UTILITIES

1 INTRODUCTION

On 15 March 2018, Hunter Water, Sydney Water, Water NSW and IPART participated in a lessons learnt workshop from the 2016-17 IPART Public Water Utility (PWU) operational audits. This workshop was beneficial and demonstrative of IPART's desire to achieve best practice regulation and to ensure that operational audits are efficient, minimise costs to the regulated PWUs and avoid broader costs to the community arising from the risk of non-compliance.

It is our understanding that IPART used feedback from this workshop to inform its *Draft Audit Guideline* (the guideline) for PWUs, published on 6 April 2018. This guideline sets out IPART's expectations regarding the conduct of operational audits and guides auditors and PWUs in carrying out their responsibilities in connection with operational audits.

We welcome IPART's update of the audit guideline and appreciate the opportunity to make a submission in response to the draft guideline. The following response offers comments on the aspects of the draft guidelines where IPART proposes material changes to the current approach. We also provide support where IPART has made improvements to the existing guidelines and suggest a number of areas where further refinement may be warranted.

2 AUDIT GRADING

Hunter Water understands that IPART has proposed changes to the audit grades to improve the consistency of compliance reporting between PWUs and WIC Act licensees and to improve consistency between the water and electricity industries. Audit grades for PWUs currently consist of three "compliant" grades, one "non-compliant" grade and "no requirement". WIC Act audit grades consist of one "compliant" grade, two "non-compliant" grades (significant/insignificant) and "no requirement".

Hunter Water has several concerns about the proposed changes to the audit grades (*Section 2.6, Section 3.1 and Appendix D*). Our concerns are detailed in the following sections.

To resolve these concerns, we would favour renaming the *non-compliant (non-material)* grade, and/or increasing the number of different audit grades and refining the audit grade definitions.

Definition and naming of the audit grades

The proposed move to one "compliant" grade and two "non-compliant" grades (non-material/material) introduces additional subjectivity in the assessment of adequate fulfilment of licence requirements, particularly in situations where there are minor shortcomings (i.e. two or more). It also introduces a risk that the active term *non-compliant* is used out of context (i.e. without the relevant materiality qualifier), which may create an inaccurate public perception of our performance and be unnecessarily emotive or alarmist.

The audit grade of *compliant* includes situations where the operating licence requirements have been "*substantially met*" (per Figure 2.1), which is insufficiently distinguished from an audit grade of *non-compliant (non-material)* where requirements have "generally been met with minor shortcomings". A minor shortcoming may rely on the auditor's interpretation of the relevant guideline or standard, of which alternative technical interpretations may also be valid. It would be harsh for the auditor to award a grade of *non-compliant (non-material)* in such a situation because

a lay reader is unlikely to be aware of the nuance between *non-compliant (non-material)* and *non-compliant (material)* nor recognise that the former does not compromise the product outcomes.

The proposed audit grades may have the unintended consequence of encouraging an adversarial relationship between the auditor and the PWU, along with more frequent escalation of issues. This potential outcome of the proposed new audit grades is reinforced by the reputational risks associated with non-compliance.

This reputational risk is particularly relevant for (drinking and recycled) water quality requirements, where the perception may be created that our water quality is non-compliant and poses a risk to public health. The term *non-compliant* used in IPART's audit grades is not necessarily consistent with the use of that term in the ADWG and Australian Guidelines for Water Recycling (AGWR). Moreover the Drinking Water Quality Management System can still be consistent with the Australian Drinking Water Guidelines (ADWG) and therefore compliant against the relevant operating licence clause, despite the auditor identifying two or more minor shortcomings.

IPART's proposed change improves consistency between the water and electricity industries. However, consistency between these industries may not be appropriate as public perception of the term *non-compliant* is likely to differ across these industries. The quality of drinking and recycled water has implications for public health, which is not necessarily comparable for the electricity industry.

Reduced number of audit grades

IPART proposes to reduce the total number of audit grades (excluding *No Requirement*) from four to three. Using fewer grades increases the difference between each grade, and therefore, the importance of marginal decisions made by the auditors about the overall grade (which relies on the auditor's interpretation of audit evidence, guidelines and standards, and the audit grading definitions).

To illustrate this point, we point out that the gap between a grade of *compliant* and *non-compliant (non-material)* is larger than the difference between a score of 80 or 81 out of 100, although in both cases only one degree separates these grades on their respective grading scale.

The overall audit grade for an operating licence clause is a summary of the substantive qualitative findings of the auditor. However, the overall audit grades are typically the headline focus by internal and external stakeholders. Increasing the importance of the auditors overall audit grade can potentially detract focus from the auditor's substantive findings and has the potential to increase contention in cases where the auditor's decision is borderline.

Disincentive to award compliant grade

An auditor cannot issue a recommendation when the utility receives a grade of *compliant*, therefore there may be a disincentive to award a grade of compliant where only minor shortcomings are identified that are worthy of a recommendation (in the auditor's view). This, coupled with the proposed definition of the *non-compliant (non-material)* grade, leads us to form the view that performance assessed as *High Compliance* using the existing grading scale is likely to receive a grade of *non-compliant (non-material)* under the new approach.

No requirement

In principle, Hunter Water agrees that an audit grade of *no requirement* is appropriate for situations where the audit scope includes an operating licence clause that is intermittently triggered and was not triggered within the audit period. Ideally, audit scoping will identify and reschedule scrutiny of those clauses to a relevant audit period.

Decision tree (Appendix D)

The audit grade decision tree (Appendix D) is inconsistent with the audit grade definitions. We note two points:

- In contrast with Figure 2.1, the criteria for a compliant grade in the decision tree does not allow a compliant grade to be awarded where requirements have been “*substantially met*”.
- The decision tree states that if a shortcoming is a “*minor non-compliance that doesn’t affect water quality, public health and safety, or the environment*”, a grade of *non-compliant (non-material)* is to be awarded. The term “*non-compliance*” in this context is not defined and may not be universally consistent with the term as used in the relevant management system standard (e.g. ISO standard) or guideline (e.g. ADWG).

As a minor observation, we note that the guideline still refers to “*full compliance*” in several places rather than the proposed new audit grades. In some situations the intent of the guideline is therefore unclear.

Hunter Water’s proposed grades

Hunter Water proposes to rename the non-compliant (non-material) grade and using the following grades:

- Compliant
- Compliant (non-material shortcomings)
- Non-compliant
- No requirement

Our proposed renaming would address many of our above-described concerns, and is more consistent with IPART’s proposed approach than increasing the number of audit grades.

3 IMMEDIATE RISK TO PUBLIC HEALTH

The draft audit guidelines includes a new section (2.3) noting “*Where auditors or IPART staff attending an audit identify an immediate risk to public health, IPART will contact NSW Health*”. This action is entirely appropriate. If such a situation was to arise, it would be appropriate that the PWU be concurrently notified so that incident management protocols can be activated.

4 AUDIT PROCESS

Completing the audit questionnaire is the most resource intensive part of the audit process for Hunter Water and imposes a significant cost.

There is merit in an alternative approach that involves the PWU providing a standard description of (and evidence demonstrating) how we comply with each auditable clause (or element under the water quality framework). The auditor would review the evidence, then provide specific targeted questions that we would subsequently respond to with additional description and evidence.

This approach would increase audit efficiency as we would not need to make wholesale changes to the descriptions each year and reframe the evidence to suit the auditor’s extensive questionnaire. Effort could then be targeted to demonstrate compliance against elements or aspects that are most important, or of interest to the auditor.

We are largely supportive of IPART’s proposed audit process and provide the following feedback to assist with finalising the guideline:

- We appreciate the opportunity provided to comment on the initial milestone schedule.
- We agree that there is merit in the PWU having a role in:
 - scheduling of interviews to ensure efficient use of interview time and that appropriate resources will be available for each interview session; and

- selecting and scheduling the field verification sites to take into account travel time considerations, ensure resource availability and that the selected site provides sufficient scope for the auditor to investigate the content they seek to audit
- Noting the auditor’s right to continue to assess evidence after the site visits and interview sessions and the significant benefit to the PWU of providing post-interview evidence, we believe that a successful audit involves the findings of the audit report broadly reflecting the sentiment and findings expressed at the audit close-out meeting. The guideline supports this aim by placing sufficient requirement on the auditor to undertake a thorough review of the evidence prior to the interviews and site visit. This is important because compliance is more difficult and less efficient for the PWU to demonstrate after this stage of the audit process.
- We would expect the auditor to be required to flag, during the close out session, any clauses that may be assigned an audit grade of *non-compliant (material)*. This would provide the PWU an opportunity to address real shortcomings. In other instances the PWU may be aware of additional evidence that could address the auditor’s concerns. We prefer the wording of the current guideline “*The auditor will flag any clauses where full compliance may not be awarded*” to the revised text providing greater auditor discretion “*The auditor may flag any clauses where full compliance may not be assigned...*” (p. 17, emphasis added).
- We are pleased with IPART’s requirement that language in the audit report is objective, factual, not overly complex or unnecessarily emotive or alarmist.
- We would appreciate receiving a copy of both the second draft and final audit report that contains tracked changes. This would allow for a more efficient and effective review of these documents by the PWU’s audit coordinator and internal stakeholders. We believe this request reflects standard general practice and does not need to be reflected in the audit guideline.
- The guideline states that the auditor will not be asked to modify its commentary or grades (p 19). We question whether this wording is consistent with other aspects of the guideline, for example, the PWU or IPART correcting any factual errors or requesting that overly alarming language be modified.

5 AUDIT MILESTONES

Historically, Hunter Water has responded to the first draft audit report with comments and additional evidence about a range of matters that are technical and reliant on specialist knowledge. This requires a wide variety of internal stakeholders with specialised knowledge to review the first draft audit report and to provide comment. As such, providing the PWU three weeks to comment on the draft report would be preferable to the proposed two week period. This allows more time to resolve any contentious issues, including a meeting between the PWU, IPART and/or auditor, if required.

We appreciate the four plus weeks that are provided to complete the audit questionnaire.

The flow and order of the audit process depicted in Table 3.2 (p 23) is clear, however, the times described in the *Timeline* column are incorrectly referenced and difficult to follow in their current form. A timeline graphic may make the timing of each step and sub-step in the audit process easier to understand.

6 RISK-BASED APPROACH

We support IPART’s use of a risk-based approach to operational audits and IPART’s stated reasons for using this approach. We consider that a risk-based approach is regulatory best practice. Using a risk-based approach to audit the elements of the water quality management

frameworks is a positive change that will lead to appropriate targeting of effort, a more detailed audit to be undertaken on key elements, and improved audit efficiency and outcomes.

The risk-based approach applied to clauses related to our management systems could be improved by Hunter Water submitting, and IPART considering the findings of Hunter Water's surveillance/certification and internal audits when setting the audit scope.

7 EVIDENCE OUTSIDE THE AUDIT PERIOD

The guideline could be improved by providing direction on how the auditor and PWU should treat evidence from outside the audit period. Possible considerations include:

- If and how relevant evidence provided from outside the audit period can influence the audit grading, or recommendations.
- If PWUs should provide superseded versions of documents if changes have been made to these documents after the audit period, and whether this relates to all changes (including minor typographical edits) or to only substantive changes.
- The treatment of evidence identified during the site visit that occurred outside the audit period (for example, a non-compliance).

These considerations are of greater importance when there is a longer gap between the timing of the audit period and the audit.

8 MATTERS OUTSIDE THE AUDIT SCOPE

Hunter Water has accepted reasonable deviation by IPART's auditors from the defined scope in past audits. It is appropriate that an out-of-scope issue is assessed by IPART's auditors if, in the course of auditing an in-scope clause, the auditor identifies that the issue may pose a significant risk to public health or the environment.

However, we note that interpretation of *"may pose a significant risk to public health"* is subjective and could potentially authorise an auditor to unreasonably stray from the audit scope. Requiring the concurrence of the IPART representative to continue the investigation outside the initial audit scope provides satisfactory protection against this occurring.

IPART's process for assessing out of scope issues and consequently reporting these to the Minister (after they are reported to IPART in the auditor's covering letter to the audit report) is not detailed in the guideline. This detail may be relevant to include if the approach differs to that undertaken for findings that are within the initial audit scope.

9 OVERLAP WITH OTHER AUDITS

It is efficient and appropriate that IPART seeks to minimise duplication of effort where there is overlap with other audits. Hunter Water maintains and implements certified management systems. These management systems undergo (re-)certification and annual surveillance audits.

IPART states (p 6) that:

"Where a system is subject to an operational audit under the PWU's operating licence, the PWU may present the outcome of any surveillance or certification (or re-certification) report to the auditor, in lieu of a formal audit. The auditor may utilise the evidence provided in its audit report. Where certified systems are not in place, we will provide specific guidance for the auditor and PWU in the audit scope on the requirements for compliance."

We will adjust our operational audit scopes to take account of these other audits. We encourage auditors to use the data and audit opinion from other relevant audits rather than duplicating the audit effort”.

This text is unclear. We seek any clarification that IPART can provide on the intent and practical implications in terms of the frequency, and/or the scope/depth of formal audits by IPART’s auditors of licence clauses related to our certified management systems. Improved clarity would avoid potential misinterpretation of this text by either auditor or PWU, and reduce inefficiency due to audit duplication. We believe that an auditor should utilise evidence provided by surveillance and/or certification audit reports, and that disregarding this evidence is likely to result in audit duplication.

10 AUDIT SCOPING FOR QUESTIONNAIRES, INTERVIEWS AND SITE VISITS

The management systems are broad, therefore, it would be beneficial if the topic areas of the management system to be investigated are clarified by the auditors so that the PWU can ensure the desired areas are covered in detail, and that the correct employees are available during the audit interviews and field verification site visit.

11 AUDITING OF REPORTING MANUAL

The operating licence reporting manual places specific reporting requirements on the PWU. These reporting requirements are often related to clauses in the operating licence. For example, the *Monthly Fluoridation Report – Drinking Water* relates to our operating licence requirements to maintain and implement a Drinking Water Quality Management System.

This relationship creates potential for auditing of our compliance with reporting obligations (through operating licence clause 6.2.1) to provide unintentionally broad scope in auditing of operating licence clauses that may otherwise be outside the scope of the audit. For example, in the course of auditing how we complied with the requirement to submit an (accurate) report on fluoride monitoring to NSW Health, there is potential for the auditor to extend the assessment to the results of the fluoride monitoring.

Although this issue has not occurred in practice, we note this possibility for IPART to consider.

12 PWU FEEDBACK

Hunter Water welcomes clause 1.4 of the guideline that explicitly encourages the PWU to provide feedback on issues and to suggest improvements. PWU feedback can assist IPART to achieve the objectives of operational audits (including efficiency and effectiveness).

13 AUDIT TIMING AND AUDIT PERIOD

Hunter Water is currently involved in discussions with IPART about the possibility of modifying the timing of our operational audit to accommodate IPART’s concerns about the availability of suitable auditors, and IPART’s internal resourcing. This may also involve modifying the audit period.

The feedback we provide in this submission reflects the context of our existing audit timing/period. Discussion of changes to the audit timing and audit period is in its infancy, and as such, our feedback has not taken into consideration how any potential changes may affect the appropriate drafting of the audit guideline.